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STATE FOR SCA/CA AND EB/IFD/OIA; STATE PLEASE PASS TO USTR

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TAGS: ECON EFIN OPIC KTDB USTR TX
SUBJECT: TURKMENISTAN 2008 INVESTMENT CLIMATE REPORT

¶1. (U) Text of Embassy Ashgabat's Investment Climate Statement for 2008 is as follows:

BEGIN TEXT OF PART I OF II:

OPENNESS TO FOREIGN INVESTMENT

Turkmenistan is a relatively large but sparsely inhabited country (about five million) with abundant hydrocarbon resources. The government regularly proclaims its wish to attract foreign investment, but its state-control mechanisms and restrictive currency-exchange system have created a difficult foreign-investment climate. Historically, the most promising areas for investment are in the oil and gas, agricultural and construction sectors. Even in these areas, companies must conduct extensive due diligence. The lack of established rule of law, inconsistent regulatory practices, and unfamiliarity with international business norms are major disincentives to foreign investment. Although President Gurbanguly Berdimuhamedov has expressed his intent to improve investment conditions, to date he has taken no specific related actions.

Turkmenistan's economy depends heavily on production of natural gas, oil, petrochemicals and, to a lesser degree, cotton and textiles. The country is the second largest gas producer in the former Soviet Union. All other existing industrial production, with the exception of food processing, needs substantial development. The country's key industries are still state-owned. According to independent estimates (European Bank of Reconstruction and Development EBRD Transition Report 2007), the private-sector share in GDP in 2006 was 25%, mostly concentrated in retail trade, services and food processing.

The top economic development priority of the Government of Turkmenistan since independence in 1991 has been self-sustainability in food supplies and an increase in import-substituting production using hydrocarbon revenues. Other industries where the government has been most receptive to foreign investment are the textile and construction sectors, which all acutely need modern technology, knowledge of international markets and experience in international

business practices. All investment proposals are screened for compliance with these government priorities. The national program entitled "Economic, Political and Cultural Development Strategy for Turkmenistan to 2020" specifies government plans for the petroleum, chemical, power generation, mining, metallurgy, textiles, construction, agriculture, transportation, communication and other industries. In October 2006, Turkmenistan adopted the Oil and Gas Development Plan for 2007-2030.

Turkmenistan has a closed investment climate. Decisions to allow foreign investment are politically driven; companies from "friendly" countries are more successful in winning tenders and signing contracts. The country has significantly reduced its foreign borrowing, particularly from international donor organizations, because of leadership fears that overseas loans may lead to political dependency on foreign states. However, since independence, Turkmenistan has accepted financing from IFIs for a variety of projects. In this environment, where the government selectively chooses its investment partners, a strong relationship with the government is essential. Often, government officials expect personal gain for allowing or helping foreign investors enter the local market. One way to penetrate the market has been to work through established foreign businessmen, who arrange deals through their personal relationship with top leaders, or via high-ranking foreign officials. Preliminary indications seem to demonstrate that establishing a personal relationship with the new president will remain the most direct -- and in some cases, the only -- way to gain entry to Turkmenistan's market.

Incoming foreign investment is regulated by the Law on Foreign Investment (last amended in 1993), the Law on Investments (last amended in 1993) and the Law on Corporations of 1999, with respect to start-up corporations, acquisitions, mergers and takeovers of

corporations. Foreign-investment activities are affected by appropriate bilateral or multilateral investment treaties, the Law on Enterprises of 2000, the Law on Business Activities (last amended in 1993), and the Land Code approved in 2004. Foreign investment in the oil and gas sector is subject to the 1996 Petroleum Law (last amended in December 2005). The Tax Code provides the legal framework for the taxation of foreign investment. The 2000 Civil Code defines what constitutes a legal entity in Turkmenistan, as well as requirements for registration. Much foreign investment is governed by project-specific presidential resolutions, which may grant privileges not provided by the general legislation.

Legally, there are no limits on foreign ownership or control of companies. In practice, the government has allowed fully-owned foreign operations only in the oil sector and, in one case, in cellular communications (MTS of Russia). There are various ways for the government to discriminate against disfavored foreign as well as domestic investors: excessive tax examinations, license extension denial, and customs clearance and visa issuance obstacles. Starwood Hotels and Resorts operated two Sheraton-franchise hotels in Ashgabat, but left Turkmenistan in 2006 as a result of disagreements over interpretation of its contract with the government.

In most cases, the government has insisted on maintaining a majority interest in any joint venture (JV). Foreign investors have been reluctant to enter JVs controlled by the government, as a result of competing business cultures and conflicting management styles. Foreign investors may only sell shares or divest with government permission, although there is no specific legislation. Coca-Cola Bottlers has been in Turkmenistan since the mid-1990s in a JV with the government.

Government efforts since 1991 to privatize former state enterprises have attracted little foreign investment. Privatization has been limited to the service and trade sectors, with most industry still in state hands. Out-dated technology, poor business structures, and governmental obstacles make privatized firms unattractive as outright purchases for foreign investors. To date, government privatization efforts have also been counteracted by lingering prejudice against the private sector. In cases where there is income potential, the government has been quick to crowd out the

private sector as a competitor.

All land is government-owned. Neither domestic nor foreign entities can receive long-term land-use rights for "non-agricultural" purposes. Private citizens have land rights under specific circumstances. However, these rights exclude the sale or mortgage of land. Land rights can only be transferred through inheritance. Foreign companies or individuals are permitted to lease land for non-agricultural purposes, but only the president has the authority to grant the lease.

The government has attempted to introduce an element of competition for state contracts by announcing international tenders for some projects. In many cases, Turkish companies have been hired to act as advisors in the tender process. Typically, these projects are politically motivated and/or economically unsound, and the tender process is badly managed and often not transparent, timely, well-prepared, or accessible. Following the president's announcement of a potential project, interested foreign investors and/or suppliers often contact the relevant government agency directly in case the tender is not announced publicly. There is one case of a U.S. company being told it was awarded a tender, investing in initial project design, and then being informed the government was considering other options. The tender was offered a second time, and the contract was awarded to a new company at double the U.S. company's tender price. Investors should always put agreed-upon terms in writing and never act on verbal promises.

Turkmenistan signed a Trade and Investment Framework Agreement (TIFA) with the United States, Kazakhstan, Tajikistan, Kyrgyzstan, and Uzbekistan on June 1, 2004. The TIFA established a regional

forum to discuss ways to improve investment climates and expand trade within Central Asia. However, the Government of Turkmenistan does not actively engage in regional efforts aimed at boosting investment projects. Turkmenistan sells electricity to Afghanistan at subsidized rates

Since independence in 1991, Turkmenistan has received an estimated $2.86 billion in foreign direct investment (FDI) (EIU Turkmenistan Country Report, October 2006). In October 2006, the Government stated that Production Sharing Agreement (PSA) operators (Petronas, Burren Energy, Maersk/Wintershall Consortium, Mitro International of Austria/Turkmennebit Consortium) had invested $1.34 billion in their local operations. The EBRD Transition Report Update (May 2006) projected net FDI for 2006 to total $308 million.

CONVERSION AND TRANSFER POLICIES

The Government of Turkmenistan maintains tight control over the country's main foreign-exchange flows. There are two de facto exchange rates. The official rate has remained fixed at 5,200 manats per dollar since 1998; for the last three years the unofficial rate has hovered around 24,000 manats per dollar. By presidential decree, as of January 1, the "unofficial" exchange rate can be no higher than 20,000 manats/dollar . In the latter part of 2006, benefiting from the steady flow of natural gas and oil income, the government began to allow banks to convert manats from some commercial entities at a near-unofficial rate of 22,800 manats per dollar. Foreign bankers considered this newly-permitted currency-exchange system to be a modest step towards overall liberalization of the foreign exchange market. The Central Bank is known to control the unofficial rate by releasing large quantities of U.S. dollars into the unofficial (but legal) exchange market.

In November 2007, President Berdimuhamedov announced his intention to unify the exchange rate by 2009. The Government of Turkmenistan also plans to release new, redenominated currency at that time. In preparation for exchange rate unification, Berdimuhamedov has stated that Turkmenistan will seek advice from international financial institutions.

Oil producers operate under the Petroleum Law and receive their profit share in crude oil, which they ship by tankers to other Caspian Sea littoral states or swap in Iran or Persian Gulf

countries. In many cases, investors in petrochemicals have negotiated deals with the Government of Turkmenistan to recoup their investment in the form of future petroleum products. Foreign investors generating revenue in foreign currency, such as textile factories, do not generally have problems with repatriating their profits. However, some foreign companies receiving income in local currency, such as Coca-Cola, seek indirect ways to convert local currency to hard currency through the purchase of petroleum and textile products in manat for resale on the world market.

Turkmenistan imports the vast majority of its industrial equipment and consumer goods. The government's foreign-exchange reserves pay for this industrial equipment and various investment projects. The demand for hard currency in Turkmenistan's private retail sector seems to be satisfied by the unofficial but legal exchange market and the newly-introduced possibility to also buy dollars in banks at the "near-unofficial" rate.

EXPROPRIATION AND COMPENSATION

Turkmenistan's legislation does not provide for private ownership of land, and thus offers opportunities for the government to force investors to vacate their land. Article 21 of the Investment Law allows investors' property to be confiscated by a court decision. Although there have been no reported expropriatory actions against foreign investors in the last year, the Government of Turkmenistan has a history of arbitrary expropriation of the property of local businesses and individuals. Under the previous leadership, the government often refused to pay any compensation, much less fair market value, when exercising "the right of eminent domain." For example, as part of a "city beautification" project to widen

Ashgabat's streets, hundreds of homes and some local businesses were destroyed. Homeowners were given short notice and little, if any, compensation for loss of their dwellings. However, during a March 2007 Cabinet of Ministers meeting, President Berdimuhamedov stated that residents of affected apartments or houses would be provided with alternative housing before their homes are demolished. In 2007, neighbors who were promised housing six months after their apartments were to be destroyed appealed to international organizations in order to obtain new housing immediately, and were given new apartments shortly thereafter.

DISPUTE SETTLEMENT

Most contracts negotiated with the government have an arbitration clause. Embassy strongly advises U.S. companies to include an arbitration clause with a venue outside Turkmenistan.

There have been several commercial disputes over the past few years involving U.S. and other foreign investors or contractors in Turkmenistan, though not all the disputes were filed with arbitration courts. Turkmenistan's investment and commercial disputes have three common themes: non-payment of debts, non-delivery of goods or services, and contract renegotiations. The government may claim the provider did not meet the terms of a contract as justification for non-payment. Most disputes have centered on the government's unwillingness to pay in hard currency as contractually required. In cases where government entities have not delivered goods or services, the government has often ignored demands for delivery. Finally, a change in the leadership of a government agency that signed the original contract often triggers a government call to re-evaluate an entire contract, including profit distribution, management responsibilities and payment schedules.

A western oil and gas company and Turkmenneft, the government-owned oil company, have been in litigation since 1996. Under the auspices of the International Chamber of Commerce, in 2001 the western company was awarded of $495 million in damages. In spring 2006, the U.S. Court of Appeals upheld the 2001 decision and bound the Government of Turkmenistan to an arbitral award rendered by a tribunal sitting in Houston, Texas, in favor of a foreign party against State Concern Turkmenneft. In November 2006, the U.S. Supreme Court denied Turkmenistan's petition for a writ of certiorari. The award has not been paid.

Although Turkmenistan has adopted a number of laws designed to

regulate foreign investment, the laws have not been consistently or effectively implemented. The concentration of power in the office of the president has undermined the rule of commercial law. Legislation is regularly made -- or overturned -- by presidential decree. The Law on Foreign Investment, as amended in 1993, is the primary legal instrument defining the principles of investment. The law also provides for protection of foreign investors. The foreign investor is defined in the law as an entity owning a minimum average of 20% of a company's assets during a calendar year, unless the Cabinet of Ministers waives the requirement.

The following is an ad hoc list of relevant legislation regarding foreign investments:

-- All foreign and domestic companies and foreign investments must be registered at the Ministry of Economy and Finance (MOEF).
--The Petroleum Law (Law on Hydrocarbon Resources) regulates offshore and onshore petroleum operations in Turkmenistan, including petroleum licensing, taxation, accounting and other rights and obligations of state agencies and foreign partners. The Petroleum Law supersedes all other legislation pertaining to petroleum activities, including the Tax Code.
-- According to the Land Code, foreign companies or individuals are permitted to lease land for non-agricultural purposes, but only the president has the authority to grant the lease. Foreign companies may own real estate property other than land.
-- Turkmenistan adopted a Bankruptcy Law in 1993.

-- Other laws affecting foreign investors include the Law on Investments (last amended in 1993), the Law on Corporations of 1999, the Law on Enterprises of 2000, the Law on Business Activities (last amended in 1993), the Civil Code enforced since 2000, and the Law on Property of 1993.

The commercial-law enforcement system includes the Arbitration Court of Turkmenistan (Arachy Kazyyet) which tries 13 categories of disputes, both pre-contractual and post-contractual, including taxation, legal foundations and bankruptcy issues. The court does not interfere in enterprises' economic relations, but considers disputes by request from either party involved. Appeals on decisions of the Arbitration Court can be filed at the Arbitration Committee of the Supreme Court of Turkmenistan.

Turkmenistan has not become a Party to the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States (also known as the Washington Convention) or the New York Convention of 1958 on the Recognition and Enforcement of Foreign Arbitral Awards or any other internationally recognized arbitration agreement.

PERFORMANCE REQUIREMENTS/INCENTIVES

Foreign investors are disadvantaged by higher tax rates than most local companies. The Tax Code adopted in 2004 was amended three times, in 2005, 2006 and 2007, but with most tax rates remaining unchanged. The Value Added Tax is 15%, an income tax of 8% is applied to JVs and an income tax of 20% to wholly-owned foreign companies and state-owned enterprises. Dividends are taxed at 15%, and the personal income tax is 10%. In 2005, the government of Turkmenistan amended the tax code, giving more concessions to domestic private companies. The Code exempted domestic private companies from the VAT and property tax and reduced the income tax from 8% to 2%. In August 2006, Turkmenistan increased its excise tax on imported beer (50%) and wine (100%). Similar taxes on domestically produced beer and hard liquor remain at previous rates: 10% and 15%-40% respectively.

In May 2007 Turkmenistan introduced a National Tourism Zone (NTZ) to promote tourism development on the Caspian Sea coast. Tax and other incentives are provided in the new legislation passed on October 1, but only to those willing to invest in construction of hotels and recreational facilities. The amendments to the Tax Code passed on October 1 exempt construction and installation of tourist facilities in the NTZ from the VAT. Various services of tourist facilities, including catering and accommodation, are also VAT-exempt. Income

tax on accommodation and catering of tourist facilities will not be levied for the first 15 years.

Equipment purchased by the investor as part of the registered capital, other assets to be used in production, and personal household effects of investors' employees are duty free.

Tax and investment incentives can be negotiated on a case-by-case basis. The president has often issued special decrees granting taxation exemptions and other privileges to specific investors while recouping the initial investment.
Assets and property of foreign investors should be insured with the State Insurance Company of Turkmenistan (Article 53 of the Petroleum Law, Article 3 of Insurance Law). National accounting and financial reporting requirements also apply to foreign investors. All contractors operating in Turkmenistan for a period of at least 183 days a year must register at the Main State Tax Service. There is a general requirement for foreign investors that 70% of the company's personnel be local. The government can make exceptions for foreign construction companies executing large-scale turnkey projects. Turkmenistan requires that all export and import contracts and investment projects be registered at the State Commodity and Raw Materials Exchange (SCRME) and the Ministry of Economy and Finance. The procedure applies not only to the contracts signed at the SCRME, but also to contracts signed between third parties. The SCRME is

government-owned and is the only exchange in the country. The contract registration procedure includes an assessment of "price justification." All import contracts must be registered before goods are delivered to Turkmenistan.

The government mostly favors long-term investment projects that do not require regular hard-currency purchases of raw materials from foreign markets. Textile factories operated by Turkish companies using domestic resources and labor serve as model investment projects supported by the government. These companies encounter relatively few currency conversion problems and enjoy tax holidays. Otherwise, there are no set requirements for local sourcing or exporting specific percentages of output.

Production Sharing Agreement (PSA) holders are mostly regulated by the Petroleum Law. They are subject to a 20% income tax and royalties ranging from 1% to 15%, depending on the level of production. The social welfare tax, 20% of the total local staff payroll, is also payable by all foreign investors and their subcontractors. PSA holders' employees and their subcontractors pay a personal income tax of 10%. Under the Petroleum Law, PSA concessions have been made to six foreign energy companies: three offshore and three onshore concessions for 20-25 years. Five of the existing concessions are in the oil sector and one in the gas sector.

Subcontractors of PSA holders can bring their equipment into the country only for a duration of a valid contract. There is no appropriate legislation that regulates operations of oil and gas subcontractors

Currently, Turkmenistan lists 94 import and nine export goods and materials subject to customs duties. Goods and materials not on the lists are subject to a 5% customs duty payment. In regard to exports, customs maintains a list of goods subject to customs duty payment. Export of fertilizers, non-ferrous metals, their alloys, and products made of non-ferrous metals is prohibited. State enterprises often receive preferential treatment; for example, wool carpets produced at state factories are exempt from customs duties. In contrast, private carpet producers have to pay 100% customs duties for exporting carpets.

Foreign investors are required to adhere to the sanitary and environmental standards of Turkmenistan. Foreign investors' products should be of equal or higher quality than prescribed by the national standards.

Turkmenistan, while not a member of the World Trade Organization (WTO), has enacted a number of laws in key areas relevant to the

WTO: investment, banking, intellectual property rights, customs, and privatization. However, the legislation is not enforced uniformly. Turkmenistan is not a signatory to and is not in compliance with the Agreement on Trade-Related Investment Measures (TRIMS).

The State Service for Registration of Foreign Citizens was created in 2003 with the specific aim of controlling access to the country and movement of foreign citizens within Turkmenistan. All visitors are required to register upon entry, and travel to most border areas requires a special permit. Inviting foreigners often is problematic, because authorities can and do deny entry visas without explanation. With these travel strictures, foreign investors trying to enter Turkmenistan for the first time have difficulty obtaining entry visas unless invited by the government. Even established investors continue to complain about bureaucratic procedures and delays in this context.
END TEXT OF PART I OF II.
HOAGLAND